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Leadership in Manufacturing

Gaining Competitive Advantage with Price Segmentation

More nuanced pricing segmentation can reveal untapped opportunities and manage numerous segments more easily and effectively.

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The Intersection of Market Needs and Technology

In today's economic climate, manufacturers seek new markets and niches as a means to sustain growth. At the same time, sophisticated technologies have come on-line with the ability to identify underserved customer segments and market opportunities with greater precision and sensitivity than ever before. These tools enable companies to manage a larger number of segments more easily and effectively.

Market segmentation has many applications, such as developing focused marketing programs, prioritizing new product development and forecasting demand across fragmented markets. Increasingly, segmentation is used to determine appropriate pricing for products and services. This article will focus on examining both the art and science that goes into creating pricing strategies that improve market and financial performance.

Customer Needs and the Role of Pricing

Every customer has different needs and priorities. If a company's pricing objective is to capture a fair share of the overall value it provides to the market, and if that value varies from customer to customer, there is an opportunity to customize your pricing strategy for maximum profit. Here are two simplified examples:

I once ran a focus group of independent automotive repair shop owners and came across two groups, two distinct sets of priorities, and two pricing segment opportunities. When asked what was most important when choosing a source manufacturer for service parts, one group responded 1) product quality, 2) availability, and then 3) price. This group tended to be ex-factory trained technicians who appreciate the importance of original parts quality and good inventory control. Another group, made up of shop owners having different backgrounds from the previous group, selected: 1) price, 2) availability, and lastly 3) product quality.

In another example, oil field operators have different needs when choosing equipment suppliers: Operators that have wells located off shore or on the north slope of Alaska require special equipment designed to operate in harsh environments and are willing to pay a premium for the specialized equipment needed. For others having no such special requirements, price is a determining factor.

Differing needs and priorities are reflected in purchase behavior. In complex markets made up of hundreds of segments, statistical analyses of historical transactions can uncover clusters of shared behaviors.

The Science

From among all customer, product and order-related attributes, the key task is to find those that correlate best with the demonstrated price response. This means testing perhaps hundreds of different variables to determine what matters most and how that varies to different groups of customers. A variety of mathematical techniques can be used, from very simple but less powerful tools that need very little user sophistication, to those that are high-powered but require a high level of expertise.

One popular statistical software package lists seven classification techniques ranging from simple classification schemes to powerful pattern recognition algorithms, such as neural networks. The more powerful ones are able to discern finer segments. Pattern recognition algorithms were developed in the 1960's for navigation purposes before GPS. They have been developed further for other applications, such as recognizing patterns in customer behavior.

As sophisticated as statistical analysis tools have become, running the numbers is only one part of the equation, and can be done by a qualified person on staff or by an outsourced consultant. Pricing software solution providers specializing in analytics also have the software tools required to run the data. However, the key ingredient is teamwork between the statistical analyst and staff who is intimately familiar with the markets and products. It is critical that an in-house market expert interpret the results and implications. In fact, raw output has been compared with the proverbial Rorschach ink blot test -- what is seen depends on the eye of the beholder. Without keen market knowledge, it's impossible to identify significant growth and profit opportunities through customer groupings.

Next, the results must be distilled down to ensure clusters are eliminated as appropriate. Considerations when eliminating particular market segments may include growth and profit potential, cost-to-serve requirements, competitive intensity, etc.

The Data: Looking Beyond Demographics

"The art of defining target markets rarely progresses beyond the assembly of somewhat dull demographics. The logical conclusion is that, if everyone is doing the same, differential advantage is difficult to attain." -- Lord Marshall of Knightsbridge, Chairman, British Airways (as quoted in the book *Market Segmentation, McDonald and Dunbar*, Elsevier, 2004).

So, what data is needed in the analysis? Most of the data required is maintained by modern pricing solutions and includes customer and product information, recent sales transaction history including win-loss data, and, preferably current customer and competitive research findings.

Pricing Strategy

In addition to customer segmentation, manufacturers must consider factors such as:

- **Product (or service) differentiation:** A classic example is good-better-best variation within a family.
- **Life-cycle stage:** Price sensitivity rises as products age. New introductions have advantages over others on the market and more customers are willing to pay a premium. Later, as newer products come on the market, customer willingness to pay declines.

- **Competitive intensity:** Products in different geographies encounter different competitive environments. Price sensitivity increases with the number of competitors.

Managing Numerous Pricing Segments

The old rule of thumb called for keeping the number of segments to as few as possible. Today, modern pricing tools have enabled automation and the ability to support complex pricing strategies. It's easier than ever before to manage a large number of segments and thereby tap many more pricing opportunities. In fact, managing hundreds of pricing segments is not unusual.

Markets change, new opportunities emerge and old ones fade. Because markets continue to evolve, segmentation needs to be refreshed regularly. How often? It depends on many factors, some of which are determined by how dynamic and complex a manufacturer's individual industry and product lines are.

More nuanced pricing segmentation using modern tools can reveal untapped opportunities and manage numerous segments more easily and effectively. So, if you are seeking new pricing opportunities and haven't reviewed your segmentation recently or if you haven't looked at it from the perspective of pricing, take a fresh look using the latest tools and techniques. Historically, there has never been a better time to take advantage of global market trends and advanced technologies for identifying and approaching opportunistic markets.

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About the Author:

Bill Huyler, Vice President Pricing Science. Bill brings over thirty years of experience in the pricing industry. His background includes roles as a pricing thought leader in the automotive and transportation industries, as well as an entrepreneur delivering both strategic consulting services and software solutions. He also served as a re-entry vehicle dynamics engineer on the Apollo and Minuteman IV programs for Northrop Aircraft and AVCO Missile Systems, respectively. He has noted that some of same mathematics used to model flight dynamics is used today to optimize prices. Bill is a long-time figure in the pricing community with many distinguished accomplishments, including a US patent in pricing methodology. He has also been a board member of the Professional Pricing Society.